

## Notes for FOMC Meeting

February 4-5, 1980

Scott E. Pardee

Since the last meeting of the FOMC, the exchange markets for the dollar have been subject to several crosscurrents. For the United States, the economic fundamentals have, if anything, deteriorated. Our latest trade figures, a deficit of \$3.1 billion for December, were a disappointment to the market. Earlier expectations of a swing into current account surplus in 1980 have pretty much been erased. A new round of oil price increases is currently under way, which will add further to our oil import bill. Also, many feel that the U.S. economy is likely to be more buoyant than previously expected. Exchange traders are particularly concerned that an increase in military expenditures in the United States, coupled with several types of election year budgetary largesse, will lead to much larger deficits this year and next than projected by the Administration.

Meanwhile, our inflation rate continues to be uncomfortably high, and hopes for early improvement have dimmed. So far the market's fears of a prolongation or intensification of inflation have not prompted renewed selling pressures on the dollar. Some market participants explain this in terms of the market's continuing positive reaction to the October 6 measures by the Federal Reserve and the System's follow-through on those measures. Interest rates have been high enough to protect the dollar from a build-up of speculative short positions, and coordinated intervention has spiked the few selling bouts which did occur.

At the same time, new interpretations of recent events have favored the dollar. Over the past three weeks, there have been no new surprises in Iran or new aggressive acts by the Soviet Union. The market's immediate concern over the implication of these problems for the dollar has begun to wane, and some traders are beginning to believe that the dollar will come out all right no matter what happens. A peaceful solution to Middle East tensions would favor the dollar. Intensification of the cold war would also help the dollar against the currencies of Western Europe and Japan. This concern has already prompted flows of funds out of Germany, out of marks, into the United States and into dollars. Whereas the mark had been bolstered in previous months by substantial

diversification out of dollars by Iranian and other OPEC interests, the net flow into marks from those sources seems to have dried up and in some cases we have heard of some return flow into dollars. The peaking out of the gold price has also helped to relax tensions in the exchange markets for the dollar. Finally, the fact that Germany has swung into current account deficit has at long last caught the attention of foreign exchange traders, and the prospect of a continuing current account deficit for Germany in 1980 is considered negative for the mark.

On balance, over the past weeks the dollar has tended to firm against most major currencies. Since the last meeting the dollar has risen a net of 1-½ percent against the German mark. This is only 2-½ percent above the record low reached earlier this year, and 3 percent below the level reached at the time of the October 6 package. The dollar has firmed against other currencies as well. An exception is sterling, which continues to be underpinned by high interest rates in London and by the market's positive attitude toward the United Kingdom's self-sufficiency in oil. The Canadian dollar also has advanced relative to all currencies, largely on energy-related considerations.

In view of the continuing concern over the economic fundamentals for the United States, the recent firming trend for the dollar is not viewed as a major turnaround. But the uptick has been a welcome respite from the recurrent selling pressures over the last half of 1979.

During this period we intervened on four occasions, selling some \$114 million worth of marks out of System and Treasury balances. Otherwise, we are able to take advantage of the large calendar of international borrowings in German marks, the proceeds of which are converted by the Bundesbank through its capital export conversion program. With marks offered to us by the Bundesbank, coupled with our purchases from other correspondents we repaid a total of \$494 million of swap drawings on the Bundesbank, reducing the outstanding debt to \$2.6 billion. We also repaid the latest \$22 million of swap debt in Swiss francs. During the period, the Treasury issued a new Carter note in the amount of 2 billion marks, thereby rebuilding its cash resources in marks.

With the dollar firming over the last few days the Bundesbank has begun to make modest sales of dollars. Since last fall the Bundesbank had accumulated a substantial sum of dollars, from the U.S. military and interest earnings, which it has held off the market

and it was only a matter of time before they began to release some of these dollars to the market. But Bundesbank officials are also candid in admitting that they do not want to see a sharp decline in the mark. These operations, while modest, risk the impression in the market that the authorities are trying to cap the exchange rate. The dollar's recovery still seems rather tenuous for us to enter a substantial program of mark purchases in the market, but we may share in some of the marks arising out of the Bundesbank's dollar sales.

REPORT OF OPEN  
MARKET OPERATIONS

Reporting on open market operations, Mr. Sternlight made the following statement.

Desk operations since the last meeting have been directed at providing reserves consistent with the monetary growth rates specified by the Committee from December to March--4 to 5 percent for  $M_1$  and about 7 percent for  $M_2$ . Reserve paths for the four weeks ending February 6 envisaged a 5 percent growth rate for  $M_1$  in January and a borrowing level around \$1 billion. As of this point, it is estimated that total reserves for the four weeks may average a little below the path--by about \$85 million. Nonborrowed reserves will be more substantially below their path, perhaps by some \$300-400 million, while borrowing may average around \$1.2 - 1.3 billion.

The modest shortfall in total reserves may have been about consistent with the slower-than-expected money growth that developed in the latter part of January. January  $M_1$  growth is currently estimated at about a 1 1/2 percent annual rate (although  $M_{1A}$ , with its somewhat different make-up and revised seasonals that should apply to the old  $M_1$  as well, may have grown at something like a 4.8 percent rate).  $M_2$ , on the old definition, grew at about a 5 1/4 percent annual rate. Apart from slower money growth, the shortfall in total reserves could also be traced in some measure to the behavior of market factors--notably a particularly large shortfall in reserves on the last day of the January 30 statement week.

The higher-than-expected level of discount window borrowing seems to have reflected a greater-than-anticipated propensity to borrow rather than unwarranted firmness in monetary conditions. As we saw the higher borrowing emerge we sought to provide nonborrowed reserves more readily in the early parts of statement weeks, and thus relieve the need for borrowing--although we sometimes drained reserves late in the week once the high borrowing had already occurred, since otherwise it was expected that total reserves would come out well above path.

In this final week, borrowing is running a bit lighter than it did in earlier weeks of the interval, averaging about \$960 million through Sunday compared with an average of \$1.4 billion in the first three weeks since the last meeting. Meantime, the money market has eased off a bit as the intermeeting period progressed, with the average weekly funds rate working down from around 13 7/8 percent to about 13 3/8 or 13 1/2 percent in recent days.

In outright operations during the interval, the System sold or redeemed about \$2.5 billion of Treasury bills--responding to the seasonal provision of reserves chiefly caused by the post-Christmas currency reflow. The total includes \$200 million of bills scheduled to be redeemed next Thursday as a result of bids in yesterday's auction. Outright operations included the sale of about \$900 million of bills in the market in mid-January. The need to absorb reserves might have been even greater but for some large declines in float in January, which may have reflected improved check transportation efforts as well as milder

weather. Matched sales purchase transactions were employed daily with foreign accounts and on a few occasions in the market, while System repurchase agreements were used on a few days in late January to make short-term reserve adjustments.

While speaking of Desk operations, I should mention, with an apology, that at the last meeting I understated the net increase in outright System holdings of Government and agency securities during the full year 1979. The increase was about \$10.3 billion on a commitment basis, not \$7.2 billion--the error reflecting a misunderstanding in the treatment of holdings reduced temporarily by matched-sale purchase transactions. The increase included \$6.2 billion of bills, \$3.7 billion in Treasury coupon issues and \$.3 billion of agency issues.

In contrast to the slightly lower Federal funds rate, most market interest rates rose during the past month, with the larger increases occurring among longer maturities. This unusual pattern, which saw some long Treasury bond prices drop as much as 7 to 9 points and long yields rise as much as 90 to 110 basis points, reflected a shift in sentiment on the business outlook, and a weakening in confidence that the long-term inflation problem can be handled successfully. Not only were the late 1979 business data stronger than expected, but also the intensifying Middle East problem and related prospects for a stronger defense build-up lent credence to those who now see the widely anticipated recession as increasingly unlikely. Expectations of a heavier corporate financing calendar have added to market pressures. In the recent market mood, the President's Budget message was greeted with

skepticism in the financial community, as they expect larger Treasury demands on the market than the official numbers suggest. The rise in unemployment reported last Friday, while long-expected, was shrugged off. Nor did the market draw satisfaction from the recent money supply weakness, as there is concern that the newly defined money measures may tell a different story. There is also a feeling that the System has relaxed its firm resolve of last October to exercise restraint. Most of these factors would tend to raise yields in all maturities, but the particularly severe adjustment at the long end seems to reflect deep discouragement about prospects for dealing successfully with inflation. Time and again one hears from the market that many traditional long-term investors are reluctant to commit funds for an extended period.

For intermediate-term Treasury issues the yield increases in the past month have been about 65 to 90 basis points, and for shorter coupon issues the rise is about 20 - 60 basis points. Dealers have kept their inventories of coupon issues light except for underwriting new issues. The market will bid tomorrow for \$3 1/4 billion of 3 1/2 year notes, with the rate expected to be around 11 1/2 percent. Wednesday is the auction of \$2 billion 7 1/4 year notes and Thursday \$2 billion of 30-year bonds, with yields well above 11 percent expected on both.

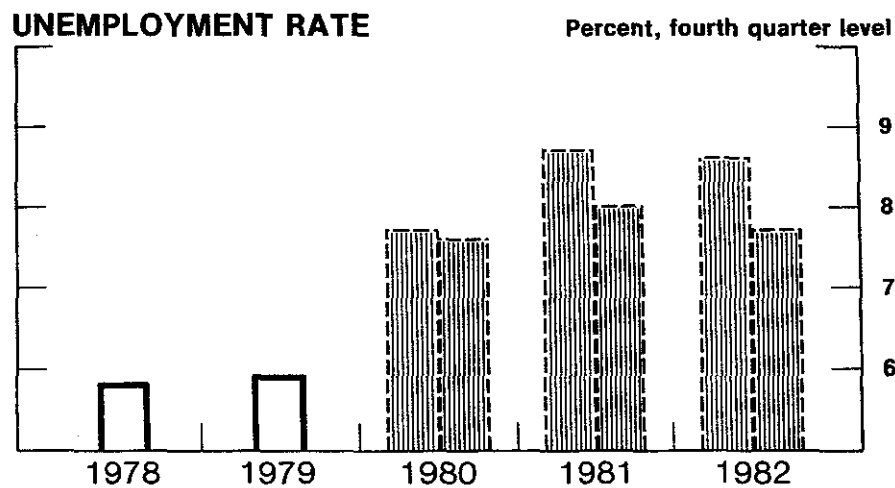
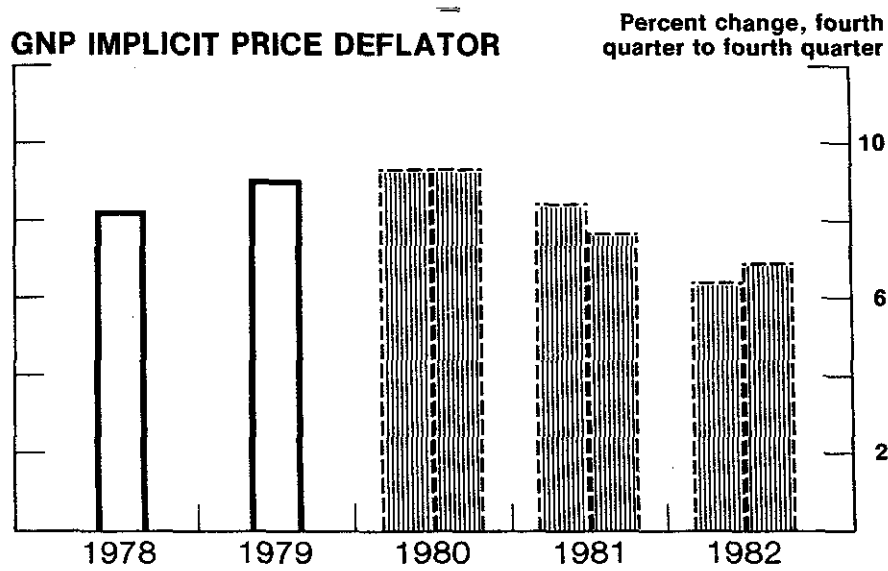
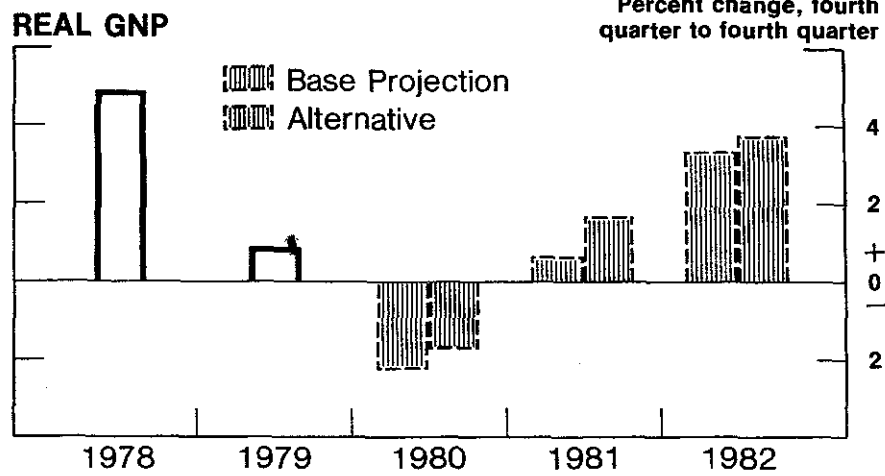
By comparison with the coupon area, most bill yields rose only moderately over the past month. Today's average 3- and 6-month rates of about 12.09 and 11.99 percent compared with about 11.94 and 11.85 percent just before the last meeting.

# COMPARISON OF STAFF AND ADMINISTRATION ECONOMIC FORECASTS

	1980		1981	
	Staff	Administration	Staff	Administration
<b>NOMINAL GNP</b>	7.0	7.9	9.0	11.7
Percent change, Q4 to Q4				
<b>REAL GNP</b>	-2.2	-1.0	0.6	2.8
Percent change, Q4 to Q4				
<b>GNP IMPLICIT DEFLATOR</b>	9.3	9.0	8.4	8.6
Percent change, Q4 to Q4				
<b>UNEMPLOYMENT RATE</b>	7 <sup>3</sup> / <sub>4</sub>	7 <sup>1</sup> / <sub>2</sub>	8 <sup>3</sup> / <sub>4</sub>	7 <sup>1</sup> / <sub>4</sub>
Q4 level, percent				



## FISCAL ALTERNATIVE—TAX CUT\*



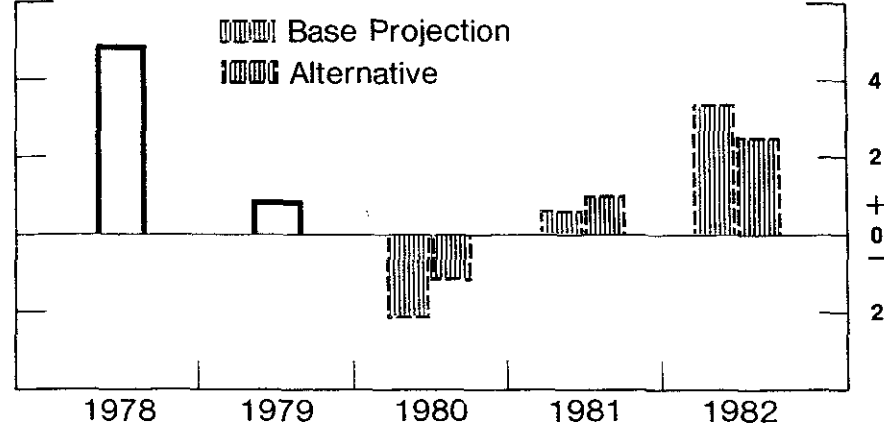
\* Consists of:

- \$10 billion cut in personal taxes mid-1980
- \$10 billion cut in corporate taxes mid-1980
- Partial rollback of social security tax increases scheduled January 1981 (\$13 billion)

# **FISCAL ALTERNATIVE—DEFENSE SPENDING\***

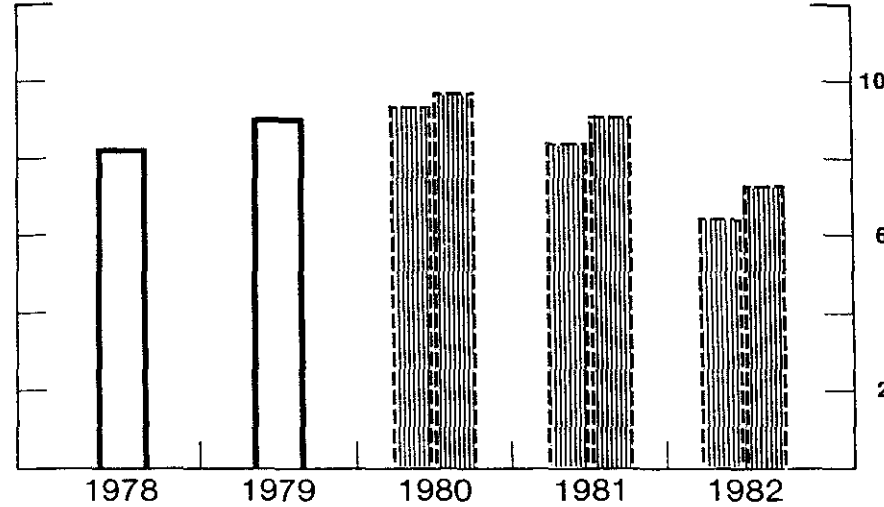
**REAL GNP**

Percent change, fourth quarter to fourth quarter



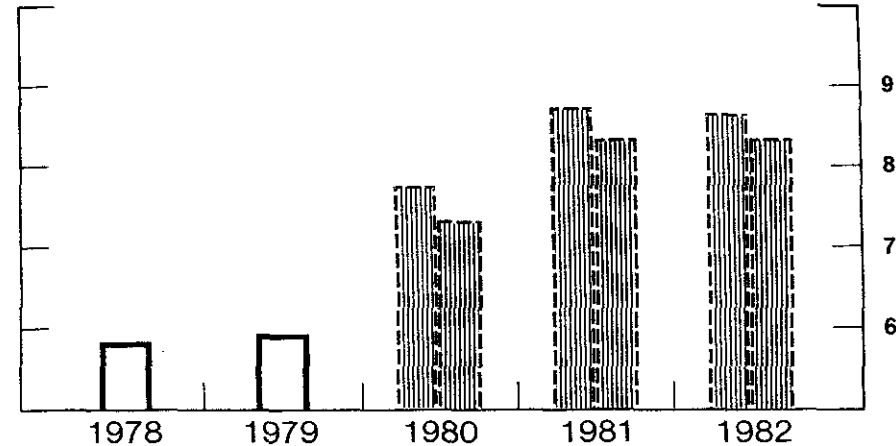
**GNP IMPLICIT PRICE DEFLATOR**

Percent change, fourth quarter to fourth quarter



**UNEMPLOYMENT RATE**

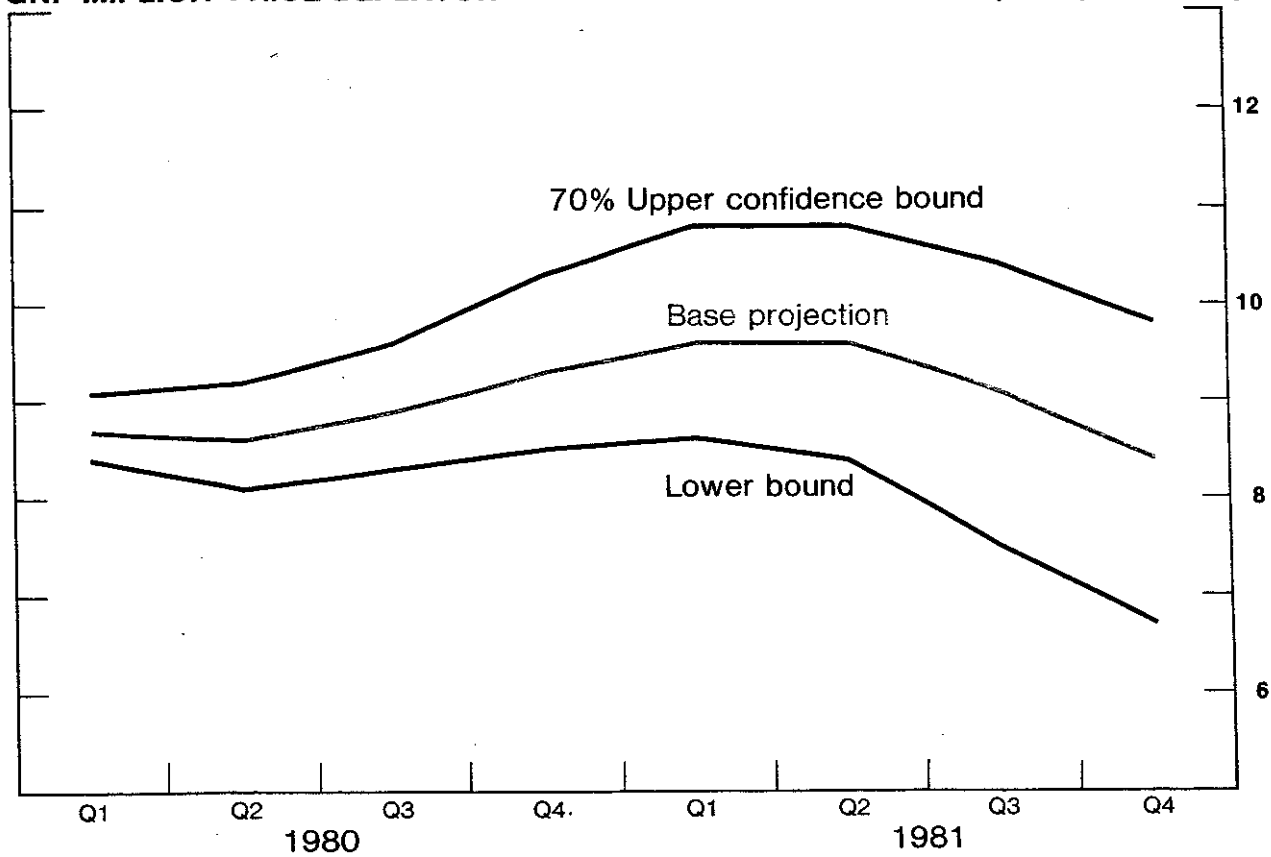
Percent, fourth quarter level



\*Defense purchases exceed those in the base projection by \$10 billion during 1980, \$20 billion in 1981, and \$20 billion in 1982.

# GNP IMPLICIT PRICE DEFLATOR

Four quarter percent change



James L. Kichline  
February 5, 1980

FOMC CHART SHOW -- INTRODUCTION

During our presentations this morning we will be referring to the package of charts distributed to you. The first chart in the package displays the principal policy assumptions underlying the staff forecast presented in detail in the Greenbook. For monetary policy, growth of M-1A is assumed at 5 percent in 1980 and 1981, around the preferences generally expressed at the Committee's January meeting, and less than had been assumed in earlier staff forecasts. For fiscal policy, we have made some adjustments in expenditures in response to newly available information, including the President's budget proposals. The forecast assumes no discretionary tax changes which is consistent with the current posture of the administration. Energy prices are assumed to continue rising rapidly, with oil import prices going up nearly one-third this year and further next year. Domestic crude oil prices will be rising faster than imported crude prices because of the decontrol program which will permit all domestic crude to move to world prices by the fourth quarter of 1981.

Both monetary and fiscal policy assumptions are interpreted as relatively restrictive over the forecast horizon in comparison with past cyclical experience. The top panel of the next chart shows the decelerating rate of growth of M-1A and M-1B built into the forecast; M-1A in fact understates growth of transactions balances in 1979 because of shifts into ATS and New York NOWs. Taking account of this, growth of M-1A slows from around 6-3/4 percent in 1979 to 5 percent. Consistent with the GNP outlook, holding M-1A to 5 percent is expected to result in a drifting down of interest rates--the lower panel--to around 11 percent for 3-month bills later this year, before moving up somewhat in 1981.

The top panel of the next chart compares the administration and staff federal budget outlooks. In fiscal 1980 outlays, receipts, and the deficit are not appreciably different in the aggregate, although we have assumed a somewhat different composition of expenditures--such as more spending for defense and less for the strategic petroleum reserve. For fiscal 1981, however, there are considerable differences related to the underlying economic outlook and other items which result in a staff budget deficit estimated at \$39 billion, well above the administration's \$16 billion figure. The widening deficit reflects the effects of automatic stabilizers; discretionary fiscal policy is continuing to move in a restraining fashion as illustrated in the bottom panel. On a high employment basis the budget moves toward restraint in 1980 and markedly so in 1981. Much of the growth in the high employment surplus in 1981 comes from social security tax increases, the windfall profits tax, and the impact of inflation on tax revenues.

The next chart shows several indicators of economic activity. Total industrial production--the top left panel--moved sideways throughout much of last year, as substantial declines in the output of motor vehicles and parts were offset by increases in production of business equipment, consumer nondurable goods, and defense items. Nonfarm employment continued to grow at a good clip in 1979, outpacing growth in economic activity. Employment growth last month--not shown on the chart--continued large but there were also signs of weakness as layoffs mounted and the unemployment rate rose 0.3 percentage point to 6.2 percent. Retail sales in real terms also have shown signs of weakening following a surge late in the summer--owing mainly to enlarged purchases of autos along with furniture and appliances. In the housing market, starts fell last quarter. All told, real GNP last quarter

is estimated to have increased at a 1-1/2 percent annual rate, with greater evidence of weakness in activity in several sectors.

Mr. Zeisel will continue the presentation with an analysis of domestic nonfinancial developments and prospects.

Joseph S. Ziesel  
February 5, 1980  
FOMC CHART SHOW

Recent developments continue to suggest to the staff that fundamental forces are moving us into recession. Given the momentum evident at year-end we expect at most only a modest contraction in the current quarter. But, as portrayed in the first chart, we do project a progressive weakening of activity later this year lasting into early '81. Recovery is projected to begin in the spring of '81, but for the year as a whole real GNP is expected to rise by only about  $\frac{1}{2}$  percent. From peak to trough, this projected contraction totals about  $2\frac{1}{2}$  percent; it falls in the middle of the range of postwar recessions in terms of severity--or about half the decline that occurred in 1974-75 when inventories were grossly out of line with sales--which is not the case today.

The consumer has played a key role in supporting activity recently, and, as is evident in the top panel of the next chart, this was accomplished in the face of virtual cessation of growth of real disposable personal income. The strength of consumer demand in the second half of 1979 appeared to represent spending to maintain normal growth of living standards in an inflationary environment and the purchase of durable goods in anticipation of continued rapid price increase. As may be seen in the middle and lower panels of the chart, this increased spending was associated with a sizable decline in the saving rate--one of the sharpest drops in the postwar years--while at the same time consumers took on historically large debt burdens.

While it has been extremely difficult to anticipate accurately consumer behavior recently, consumer spending propensities would appear to be vulnerable to any further weakening in real income growth, given debt burdens and low saving rates. And, as is evident in the top panel of the next chart, just such a decline in real income appears to be in prospect. Although employment gains have slowed this past year, the growth of jobs has been out-running production advances, and some downward employment adjustments are long overdue. If these occur, as we expect, in conjunction with continued sharply rising prices, it seems very likely that 1980 will witness a decline of real disposable income. After-tax income will be cut further by a large increase in social security taxes scheduled for the beginning of 1981.

While it is possible that consumers will continue to strive to maintain living standards, the Michigan survey suggests that the public has recently moved away somewhat from the buy-in-advance-of-inflation rationale that seemed to have bolstered durable goods purchases. And, as is evident in the middle panel, income otherwise available for the purchase of luxuries is increasingly being absorbed by skyrocketing energy prices. As the bottom panel indicates, these various factors have led us to expect a very sluggish outlook for real consumer demand--a decline in 1980 and very little change in 1981.

Housing is also likely to continue to be a negative factor in overall growth, particularly during the next few quarters. As is evident in the top panel of the next chart, deposit growth at thrift institutions weakened further following the Fed's October 6 policy actions. In conjunction with high interest rates, this has led to a sharp reduction in outstanding mortgage lending commitments--the lower panel. While the supply of funds from sources such as housing bonds and mortgage passthroughs should cushion the housing decline, demand factors are also expected to be a major influence damping construction activity this year. The top panels of the next chart give dramatic evidence of the weakening of demand recently. Sales of new homes have fallen substantially since last fall and the average price of new homes has declined sharply; such a decline in prices, if sustained, could well blunt the investment motive for purchasing single-family homes and condos.

As indicated in the bottom panel, we are now forecasting housing starts to drop to a 1.4 million annual rate in the first half of this year. Starts are expected to turn up by the fall, as activity benefits from some easing in mortgage rates which will permit an emergence of underlying demand associated with population and migration trends.

Turning to the business sector, the top panel of the next chart indicates the recent trend in real orders for capital equipment. While new orders have edged up in the past few months, their level remains below that of the first quarter. These figures foretell weaker growth in business fixed investment. They are generally consistent with the results of the latest plant and equipment survey, which shows an increase of only about 1 percent in real terms for 1980 as a whole--and implies a downturn later this year.

The outlook for capital spending in 1981 is obviously more uncertain. But as indicated in the middle panel, we are projecting a further drop in capacity utilization rates in manufacturing as markets weaken, leading to reduced pressure for expansion of capital stock,



particularly given poorer profit performance and continued high normal interest rates. As the bottom panel shows, we thus foresee a continued, although far from precipitous, decline in real capital outlays through much of next year.

The rate of inventory investment over the next two years is expected to reflect largely developments in fixed capital spending and other final demands. As is indicated in the top panel of the next chart, the deterioration of auto demand in the spring of 1979 resulted in a backup of dealers' stocks of large, less fuel-efficient cars, but a combination of production adjustments and price-cutting eased that problem considerably. As shown in the middle panel, by the fall overall business inventory/sales ratios were almost back to levels of 1977 and 1978. We anticipate that businessmen will continue to keep stocks generally in line with sales. As is evident in the bottom panel, this implies some liquidation of stocks from mid-1980 through early 1981. A recovery in stock building should get under way later in 1981 as aggregate sales pick up. Throughout the forecast period we have allowed for some inventory accumulation in line with the rise in defense spending that now appears in process.

The pickup now scheduled in 1980 and 1981 for federal defense spending, other than personnel compensation, is portrayed in the top panel of the next chart. In real terms we now anticipate a rise in these defense purchases of about 7 percent in both the current and coming fiscal years--much more than in the last five years. All of the expected increase will be in procurement, operations, and research. Our figures are slightly larger than those in the Administration's budget and give additional upward thrust to total federal spending. But the overall rise in government purchases is projected to be blunted somewhat by continued restraint in nondefense outlays. Moreover, we anticipate that increases in federal spending will be offset by reduced real outlays at the state and local level as these jurisdictions respond to high interest rates and a squeeze on receipts. Thus, as is portrayed in the middle panel, in aggregate real government purchases of goods and services are expected to increase only a little faster in the next two years than last year. Nevertheless, as a share of GNP, these figures do rise in '80 and '81, reversing the downtrend in this ratio that has been evident for five years.

The top panel of the next chart portrays the projected contraction in real nonfarm output and the associated employment adjustment. As is evident, employment gains in 1979--while smaller than in previous years--were dramatically out of line with the fractional rise in nonfarm output. It seems reasonable to assume that some of this "hoarded" labor will be disgorged in

the near future as businessmen recognize that output is not rising rapidly enough to justify their retention. We are forecasting a decline of about 1-½ million nonfarm jobs from peak to trough, with the impact greatest in durables manufacturing.

We are also projecting a slower growth of the labor force--the middle panel--reflecting mainly poorer job prospects. But the unemployment rate--shown in the bottom panel--is projected to move up fairly sharply this year to about 7-¾ percent by the fourth quarter, and to drift up further during 1981, reaching 8-¾ percent by the end of the next year.

Rising unemployment can be expected to result in some damping of wage pressures, but labor costs nonetheless are likely to continue rising rapidly in the near term, for several reasons. First, as is evident in the top panel of the next chart, growth of compensation in 1979 fell sharply behind the rise in consumer prices. This should lead to attempts at wage catch-up in the latter half of 1981. And of course, the feedback effects of earlier energy price increases on wages and other costs will still be fueling inflation. We are assuming that food prices will move about in line with other prices over the next two years.

Finally, the next chart shows our current view of the outlook for overall inflation. On balance, we expect that the combination of a protracted period of slack markets, some improvement in productivity, and a moderation in the upward trend of energy prices will ease the inflation situation somewhat in late 1980 and in 1981. We are projecting overall prices to be rising at about an 8 percent rate by the end of 1981.

Mr. Truman will continue with a review of the international part of the projection.

CHART SHOW PRESENTATION

E.M. Truman

February 5, 1980

The upper left hand panel of the first international chart illustrates the dramatic shift over the past year in the cyclical situation of the United States relative to foreign industrial countries. The line shows the ratio of U.S. real GNP to the average of real GNP in other G-10 countries and Switzerland. Over the past four quarters, U.S. real GNP has expanded at about a 1 percent rate and foreign real GNP rose by about 3-1/2 percent. During 1980, while U.S. real GNP is expected to decline--as Mr. Zeisel has explained--foreign growth is expected only to moderate to about 1 percent. During 1981, foreign growth is expected to pick up and be about 2 percent faster than U.S. growth. These cyclical factors, along with oil, dominate our projection of U.S. international transactions.

As is shown in the upper right hand panel, the volume of non-oil imports is expected to decline this quarter. The decline continues through the first quarter of 1981 and then is reversed later next year. Because of rising import prices, the value of non-oil imports declines less in 1980 and later rises more rapidly.

The lower left hand panel indicates that the volume of non-agricultural exports is expected to expand much more moderately over the forecast period than has been the case for the past two years. Again, however, inflation imparts a big boost to the value of these exports.

The lower right hand panel presents our outlook for oil imports. Sharply higher oil prices--as described by Mr. Kichline--and weak U.S.

activity should produce a cutback in the volume of oil imports, but the higher prices will raise the value of oil imports to \$90 billion, at an annual rate, by the end of 1981.

The second chart summarizes our external projection. The top panel shows that we expect a sharp increase in our trade and current account deficits this quarter as the result of lost grain and gold exports and because of higher oil prices. Thereafter, cyclical conditions predominate, pushing the current account into significant surplus by the fourth quarter of this year.

In terms of the GNP accounts, illustrated in the last two panels, real exports of goods and services are expected to decline slightly in 1980 reflecting lower agricultural exports and reduced service receipts. During 1981, we expect real exports of goods and services, on a GNP basis, to expand quite slowly, though somewhat faster than the rest of the economy. Thus, the rise in real GNP net exports of goods and services, depicted in the bottom panel by the red line, reflects mainly the cyclical decline in real imports of goods and services throughout most of the projection period.

Mr. Kichline will now complete our presentation.

James L. Kichline  
February 5, 1980

FOMC CHART SHOW -- CONCLUSION

The first chart in the final section of your packet shows the volume of funds raised by nonfinancial sectors. Total funds raised declined last year from their peak in 1978 despite 10 percent growth of nominal GNP; the drop in the total reflected smaller federal government net financing while private borrowing was essentially unchanged for the year. Late in the year, however, private borrowing did drop off and we expect both demand and supply side constraints to result in a lower level of funds raised in 1980 than last year and little growth in 1981. Total funds raised relative to GNP, the lower panel, declined nearly 3 percentage points last year and is projected to decline further over the forecast horizon. A drop in this ratio is characteristic of recessionary periods.

The top panel of the next chart shows that reduced borrowing by households contributed appreciably to a recent reduction of private credit demands. Household borrowing declined in the second half of last year as both mortgage and other borrowing slackened--reflecting the reduced pace of spending on consumer durables and a slower pace of real estate activity. Household borrowing is projected to trend lower this year and to turn up a little in 1981 as activity recovers.

Total borrowing by nonfinancial corporations, the lower panel, also moved lower in the second half of last year and is expected to remain well below the early 1979 peak through 1981. External financing needs are projected to be held down by the sluggish growth of capital expenditures and little, if any, inventory accumulation. At the same time corporate financial

positions are likely to remain tight in the aggregate, with a need to fund some of the large volume of short-term debt taken on in the past few years. However, double-digit long-term rates may well act to restrain a major move into permanent financing.

The next table provides a comparison of the staff and administration economic forecasts. In 1980 the forecasts are not greatly different, and well within the range of uncertainty associated with point estimates. For 1981, however, the administration is forecasting considerably larger expansion of nominal GNP stemming from a faster economic recovery; prices are projected to rise about the same as in the staff forecast while the unemployment rate is 1-1/2 percentage points lower. The strong performance of real GNP seems to arise out of a higher pattern of consumer expenditures related in part to a savings rate that remains rather low. In addition, financial conditions implicitly are a good deal easier--the bill rate is assumed to fall more than 2 percentage points by the summer and by another 1 percentage point a year later. Irrespective of the monetary assumptions, however, experiments with the quarterly econometric model suggest there is a reasonable chance of hitting the administration inflation forecast, but a very low probability of obtaining or bettering both the inflation and the unemployment goals of the administration in 1981.

These experiments with the econometric model provide a formal way of assessing the uncertainty associated with a given forecast and are based upon errors in the equations of the model. But uncertainty may arise from the policy assumptions as well. In the current situation a good deal of uncertainty attaches to the fiscal assumptions. The next chart indicates the results derived from a fiscal alternative involving a tax cut. The tax

cut provides a spur to real GNP growth in 1980 through 1982 compared to the base projection, and carries with it a lower unemployment rate--the bottom panel. In 1981 the rate of increase of the deflator is also lower, reflecting the effects of the assumed partial rollback of social security tax increases, but prices in 1982 once again are rising faster owing to the higher level of activity. A cut in social security taxes alone would provide less impetus to real activity and employment growth but would carry with it a reduction in the price level from what would prevail otherwise.

The next chart shows the results of a different fiscal alternative involving appreciably more defense spending than in the base projection. The projected outcome involves more real GNP in 1980 and 1981 than in the base projection but more inflation as well. By 1982, however, real GNP expansion falls below that in the base projection as holding to a 5 percent money growth with accelerating inflation produces higher interest rates and begins choking off activity. Such an alternative is likely to have even larger effects than produced by the econometric model since rapid defense increases undoubtedly would affect business and consumer attitudes as well as result in bottlenecks that would intensify inflationary pressures.

None of these alternatives suggests an outcome that is particularly encouraging in the short- and medium-term. The last chart in the package indicates that the deeply ingrained inflation and inflationary expectations are the nub of the problem. Adapting the base projection to the econometric model provides an estimate of the range of uncertainty around the price forecast. As indicated, by the fourth quarter of 1981 there is a 70 percent probability that prices will be rising somewhere between 9-3/4 and 6-3/4 percent; alternatively expressed there is only a 15 percent chance

that inflation will be less than the 6-3/4 percent lower bound at that time. These probabilities of course would change to the extent that, for example, a mandatory wage-price control program is instituted or wage and price expectations are formed in ways different from past experience. But, judging from history, the likelihood of achieving both attractive inflation and unemployment outcomes in the shorter run does not seem high given the structure of the economy.